The Commonwealth of Massachusetts
Office of the Comptroller
One Ashburton Place, Room 901
Boston, Massachusetts 02108

MARTIN J. BENISON
COMPTROLLER

PHONE (617) 727-5000
FAX (617) 727-2163
INTERNET http://www.mass.gov/osc

Component Unit Guidance – FY 2006

Issue Date: Immediately

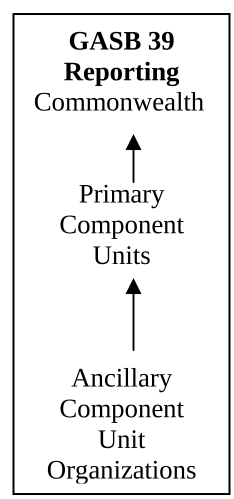
Effective Date: Immediately until superseded

Executive Summary

This guide supersedes the existing Component Unit Guidance previously issued in 2005. It is meant to compliment the Government Accounting Standards Board (GASB) Statement 34 implementation guide issued in 2002. This guide incorporates implementation of GASB Statements 39, 40, 42, 44, 46 and 47 and to reissue policies on required documentation with regard to the Commonwealth's issuance of its Comprehensive Annual Financial Report (CAFR). A decision tree is attached as an appendix to this document, which allows you to assess whether or not a related entity to your organization is a Component Unit.

Considerations

The Office of the Comptroller prepares a CAFR annually. All entities in receipt of Federal Funds in excess of $500,000 are required to have a Single Audit in accordance with OMB Circular A-133. If you are required to have the A-133 audit, please inform us. We need to ensure the audit and the timing of the related report issuance are consistent with the Commonwealth's timelines.



Reporting standards require that all Primary Component Unit (e.g. existing component units or Authorities) financial statements be included as part of the Component Unit discrete presentation for the Commonwealth. **Due to the tight timetable of completing the CAFR and the large number of Primary Component Units, we are requesting that each separately audited Entity read and complete the financial statement package.**

Statement 39 extends the requirements of component unit reporting, potentially integrating other related organizations to a primary component unit or the Commonwealth itself. The Office of the State Comptroller performed a data analysis and at this point, we know of no other organization that may rise to the level of a component unit for the Commonwealth. However, other related entities may be part of your primary component unit. Should your entity have these new organizations, to facilitate this reporting, these entities' audited financial statements are recommended to be submitted on a timely basis to your Authority, (typically one month prior to October 16, the due date for the Authority's completed audited financial statements to be received at the Office of the Comptroller). Completed audits are defined as audits in final form, **represented to the Office of the Comptroller as ready for acceptance by or accepted by the Governing Body of the Authority**. Various reporting changes and footnote disclosures are necessary for proper reporting.

FY 2006 GUIDANCE

Reporting Requirements

It is our hope that you will communicate with us if there have been changes in your organization that will effect your financial reporting. If you foresee any problem meeting the **October 16th** deadline please call Eric Berman at (617) 973-2602 or B J Trivedi at (617) 973-2663.

This year the Commonwealth is scheduled to issue its audited CAFR no later than December 15th.

- **Submit copy of drafts financial statements (ready for your board's review) to the Office of the Comptroller by October 2nd.**
- **Final audited financial statements must be submitted to the Office of the Comptroller by the due date of October 16th.**

The financial statements of the Authority must be received by the Office of the Comptroller in a form ready for acceptance by the Governing Body i.e., audited and have received an unqualified audit opinion. **The Commonwealth's financial statements are at risk of being qualified by our auditors if you do not meet the above requirements.**

Reporting requirements require entities that receive federal funding must be audited in accordance with generally accepted governmental auditing standards. The audit opinion of these entities should read, "audited in accordance with *Governmental Auditing Standards.*"

Independence Letter

The Primary Component Unit's audited financial statements must be transmitted to the Office of the State Comptroller with a copy of the *Independence Letter and the original going to Deloitte & Touche, LLP*. It is necessary for your auditors to confirm to our auditors, (currently Deloitte & Touche, LLP) their independence with regard to your financial statements. This requirement is ***mandatory*** and any lack of response may result in a qualification of the Commonwealth's CAFR audit opinion. As the component units of the primary component unit are also audited, these component units <u>must also transmit their audits to the Primary Component Unit's auditor containing a similar letter</u>. The letter that the primary component unit needs to transmit to the Commonwealth's auditors and the component unit(s) need(s) to transmit to the primary component unit is below. In the case of a letter from the Primary Component Unit's auditor to the Commonwealth (the addressee would change if addressed from the component unit of the Authority to the Authority's Auditor:)

Audit Independence Letter

October 16, 2006
(or earlier)

Deloitte LLP
200 Berkeley Street
Boston, MA 02116
Attention: Daniel Bonnette

This letter is furnished to you in response to your request for certain representations by us in connection with your audit of the general purpose financial statements the Commonwealth of Massachusetts, which will include the financial statements of the **(Insert Name of Authority),** ("the Authority"), for the fiscal year ending June 30, 2006. (*Note – the Turnpike Authority is a calendar year.)*

We have been engaged to audit the financial statements of the Authority for the year ending June 30, 2006. The purpose (and therefore the scope) of our audit is to enable us to express an opinion on the financial statements of the Authority; accordingly, we will have performed no procedures directed solely toward identifying matters that might affect your report or your audit of the financial statements of the Commonwealth. In this connection, we represent to you the following:

1. We are familiar with the standards of the American Institute of Certified Public Accountants (Code of Professional Conduct Rule 101 and related interpretations) regarding independence of accountants. We have been independent with respect to the Authority, the Commonwealth of Massachusetts, and its other affiliates during the course of our audit to the date of this letter. We expect to continue to be independent with respect thereto through the date of our report on our audit of the financial statements of the Authority; we will inform you promptly if during that period we become aware of any circumstance that impairs our independence.

2. We are aware that the financial statements of the Authority for the year ending June 30, 2006 will be discretely presented as part of the general purpose financial statements of the Commonwealth of Massachusetts for the year then ending, and that our report on our audit of the financial statements of the Authority will be used by you as a basis, in part, for your report on your audit of the general purpose financial statements of the Commonwealth of Massachusetts.

3. We will review the conformity of the accounting principles used by the Authority with the significant accounting policies prescribed by the Government Accounting Standard Board (GASB) for entities included in the general purpose financial statements of the Commonwealth of Massachusetts, and we will advise you of any material departures therefrom that come to our attention.

4. We will conduct our audit of the Authority's financial statements in accordance with generally accepted auditing standards and, as appropriate, Government Auditing Standards issued by the Comptroller General of the United States of America, and we will inform you promptly of any restriction on the scope of our audit, whether imposed by the Authority's management or other circumstances.

5. We are familiar with accounting principles generally accepted in the United States of America and with the generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants and the *Government Auditing Standards* issued by the Comptroller General of the United States. We are conducting our audit and will report on the results thereof in accordance with those standards.

6. We have knowledge of the relevant reporting requirements for financial statements and required supplemental information and schedules to be included in the Comprehensive Annual Financial Report of the Commonwealth of Massachusetts.

Yours truly,

(Name & Title)
(Independent Certified Public Accounting Firm)

Relevant GASB Standards

The financial statements must be prepared in accordance with Generally Accepted Accounting Principles (GAAP) as promulgated by the Governmental Accounting Standards Board (GASB). All relevant standards must be followed. The following standards became applicable in FY2006.

Statement	Description	Implementation FY
42	***Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries***	**2006**
44	***Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement 1***	**2006**
46	***Net Assets Restricted by Enabling Legislation***	**2006**
47	***Accounting for Termination Benefits***	**2006**

The Office of the State Comptroller has scheduled a meeting for **April 26, 2006 at Bunker Hill Community College** to review these standards and the forthcoming GASB 45. Should you not be available to attend this session, the following is a summary of the new standards being implemented in FY2006:

Statement No. 42 - *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*

Statement 42 establishes accounting and financial reporting standards for impairment of fixed assets. A fixed asset is considered impaired when its service utility has declined significantly and unexpectedly. Clarification is also included for accounting requirements for insurance recoveries.

Governments are required to evaluate <u>prominent events</u> or changes in circumstances affecting capital assets to determine whether impairment of a capital asset has occurred. Such events or changes in circumstances that may be indicative of impairment include:

- Evidence of physical damage,
- Enactment or approval of laws or regulations or other changes in environmental factors,
- Technological changes or evidence of obsolescence,
- Changes in the manner or duration of use of a capital asset, and
- Construction stoppage.

A capital asset generally should be considered impaired if **<u>both</u>** (a) the decline in service utility of the capital asset is large in magnitude and (b) the event or change in circumstance is outside the normal life cycle of the capital asset.

Impaired capital assets that will no longer be used by the government should be reported at the lower of carrying value or fair value. Impairment losses on capital assets that will continue to be used by the government should be measured using the method that best reflects the diminished service utility of the capital asset. Impairment of capital assets with physical damage generally should be measured using a restoration cost approach, an approach that uses the estimated cost to restore the capital asset to identify the portion of the historical cost of the capital asset that should be written off. Impairment of capital assets that are affected by enactment or approval of laws or regulations or other changes in environmental factors or are subject to technological changes or obsolescence generally should be measured using a service units approach, an approach that compares the service units provided by the capital asset before and after the impairment event or change in circumstance. Impairment of capital assets that are subject to a change in manner or duration of use generally should be measured using a service units approach, as described above, or using deflated depreciated replacement cost, an approach that quantifies the cost of the service currently being provided by the capital asset and converts that cost to historical cost.

Statement No. 44 - *Economic Condition Reporting: The Statistical Section*

This statement only applies to entities that produce Comprehensive Annual Financial Reports. As such, it does not apply to most entities that interface into the Commonwealth's CAFR. Those entities that do produce CAFR's independently will receive specific guidance.

Statement No. 46 - *Net Assets Restricted by Enabling Legislation—an amendment of GASB Statement No. 34*

This Statement clarifies that a legally enforceable enabling legislation restriction is one that a party <u>external to a government</u>—such as citizens, public interest groups, or the judiciary—<u>can compel a government to honor</u>. The Statement states that the legal enforceability of an enabling legislation restriction should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if a government has other cause for reconsideration. Although the determination that a particular restriction is not legally enforceable may cause a government to review the enforceability of other restrictions, it should not necessarily lead a government to the same conclusion for all enabling legislation restrictions.

Statement No. 47 - *Accounting for Termination Benefits*

This Statement establishes accounting standards for termination benefits. Recognition is similar to that in private industry.

Recognition Requirements

In financial statements prepared on the accrual basis of accounting, employers should recognize a liability and expense for *voluntary* termination benefits (for example, early-retirement incentives) when the offer is accepted and the amount can be estimated. A liability and expense for *involuntary* termination benefits (for example, severance benefits) should be recognized when:

- A plan of termination has been approved by those with the authority to commit the government to the plan,
- The plan has been communicated to the employees, and
- The amount can be estimated.

For financial reporting purposes, a *plan of involuntary termination* is defined as a plan that (a) identifies, at a minimum:

- The number of employees to be terminated,

- The job classifications or functions that will be affected and their locations, and
- When the terminations are expected to occur. And (b):
- Establishes the terms of the termination benefits in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.

If a plan of involuntary termination requires that employees render future service in order to receive benefits, the employer should recognize a liability and expense for the portion of involuntary termination benefits that will be provided after completion of future service ratably over the employees' future service period, beginning when the plan otherwise meets the recognition criteria discussed above.

In financial statements prepared on the modified accrual basis of accounting, liabilities and expenditures for termination benefits should be recognized to the extent the liabilities are normally expected to be liquidated with expendable available financial resources.

Measurement Requirements

Healthcare-related termination benefits that are provided as the result of a large-scale, age-related program (for example, an early-retirement incentive program that affects a significant portion of employees) should be measured at their discounted present values based on projected total claims costs (or age-adjusted premiums approximating claims costs) for terminated employees, with consideration given to the expected future healthcare cost trend rate. Employers that provide healthcare-related termination benefits that are not part of a large-scale, age-related termination program are permitted, but not required, to measure the cost of termination benefits based on projected claims costs for terminated employees. That is, in this circumstance, the cost of termination benefits may be based on unadjusted premiums.

The cost of non-healthcare-related termination benefits for which the benefit terms establish an obligation to pay specific amounts on fixed or determinable dates should be measured at the discounted present value of expected future benefit payments (including an assumption regarding changes in future cost levels during the periods covered by the employer's commitment to provide the benefits). If, however, the benefit terms do not establish an obligation to pay specific amounts on fixed or determinable dates, the cost of non-healthcare-related benefits should be calculated as either (a) the discounted present value of expected future benefit payments or (b) the undiscounted total of estimated future benefit payments at current cost levels.

Termination Benefits That Affect an Employer's Defined Benefit Pension or OPEB Obligations

As an exception to the general recognition and measurement requirements discussed above, the effects of a termination benefit on an employer's obligations for defined benefit pension or other postemployment benefits should be accounted for and reported under the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers,* or Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* as applicable.

Disclosure Requirements

This Statement requires employers to disclose a description of the termination benefit arrangement, the cost of the termination benefits (required in the period in which the employer becomes obligated if that information is not otherwise identifiable from information displayed on the face of the financial statements), and significant methods and assumptions used to determine termination benefit liabilities.

Standardized Financial Reporting Items

For Authorities receiving federal funding:

Reporting requirements require entities that receive federal funding need to be audited in accordance with generally accepted governmental auditing standards. The audit opinion of these entities should read, "audited in accordance with Governmental Auditing Standards issued by the Comptroller General of the United States of America."

A series of supporting schedules have also been included as part of this package. The primary purpose of these schedules is to complete the required footnote disclosures and to assist in the reconciliation of the activity between the Commonwealth and the component unit. **The timely submission of these schedules are critical since a series of material adjustments to the Commonwealth's other funds are required due to its component units.**

Management's Discussion and Analysis

The Management's Discussion and Analysis (MD&A) of the Primary Component Unit is typically limited to discussion of the Primary Component Unit's activities. Only a very significant or unusual transaction involving the Component Unit needs to flow up to the MD&A of the Primary Component Unit. For all years, the relationship and the nature of transactions between the Commonwealth and the Authority should also be discussed.

Audit Opinion

The opinion for all years should reference the work of the auditor of the Authority and the level of reliance on that work. The **component unit's opinion must reference *Government Auditing Standards*** if the entity is required to have an audit performed in accordance with those standards (e.g is required to have a Single Audit performed of their financial statements)***.***

In addition, your entity needs to have an unqualified audit opinion. The Commonwealth's financial statements are at risk of a qualification of our auditor's opinion if you do not meet the above requirements.

Footnote Disclosures from Component Units

Statement 34 and Statement 14 require that an overview of the Primary Component Unit should distinguish between the Primary Component Unit and the Component Unit(s). For each major component unit, the nature and amount of significant transactions with the Primary Component Unit should be disclosed, along with any other transactions between Component Units.

Disclosures for the Component Units should be limited to those that are essential to the fair presentation of the Primary Component Unit's basic financial statements. This needs to be done on a case-by-case basis. For example, for a component unit that is a 501(c)3 foundation, cash, investments, receivables, fixed assets, payables and debt, if applicable, would be disclosed. The focus on disclosure needs to be on information from only *major*

Component Units. Finally, a reference needs to be made in the Primary Component Unit's footnotes as to how to obtain the Component Unit's audited financial statements in describing the Component Unit relationship.

Other Financial Reporting Guidance

The financial statements should <u>include</u> all of activities, which is to say it should include all activity as measured and reported in conformity with GAAP, including any component unit(s) of the Authority.

Transmittal Document to the Office of the State Comptroller

As an appendix to this document, an information transmittal form is attached that needs to accompany your financial statements. Please use it in conjunction with the diskette's information.

Specific Guidance for GASB Statement 40 including Questions and Answers Guide

See link below for the Guidance for GASB Statement 40
http://knowledgecenter.osc.state.ma.us/KC/KCDisplayPage.asp?page=Reports_Audits/GASB/2005/GASB_40_Implementation.pdf

Forthcoming GASB Standards

The following standards have been issued as of the date of posting and will be implemented in the following fiscal years:

Statement	Description	Implementation FY
43	*Financial Reporting for Postemployment Benefit Plans Other than Pension Plans*	2007 unless largest government in plan implements earlier
45	*Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*	2008

GASB STATEMENT 45 ON OPEB ACCOUNTING BY GOVERNMENTS
A FEW BASIC QUESTIONS AND ANSWERS

1. **Why was Statement 45 on OPEB accounting by governments necessary?**

   Statement 45 was issued to provide more complete, reliable, and decision-useful financial reporting regarding the costs and financial obligations that governments incur when they provide postemployment benefits other than pensions (OPEB) as part of the compensation for services rendered by their employees. *Postemployment healthcare benefits,* the most common form of OPEB, are a very significant financial commitment for many governments.

2. **How was OPEB accounting and financial reporting done prior to Statement 45?**

   Prior to Statement 45, governments typically followed a "pay-as-you-go" accounting approach in which the cost of benefits is not reported until after employees retire. However, this approach is not comprehensive—only revealing a limited amount of data and failing to account for costs and obligations incurred as governments receive employee services each year for which they have promised future benefit payments in exchange.

3. **What does Statement 45 accomplish?**

   - When they implement Statement 45, many governments will report, for the first time, annual OPEB cost and their unfunded actuarial accrued liabilities for past service costs. This will foster improved accountability and a better foundation for informed policy decisions about, for example, the level and types of benefits provided and potential methods of financing those benefits.

   The Standard also:

   - Results in reporting the estimated cost of the benefits as expense each year *during the years that employees are providing services* to the government and its constituents in exchange for those benefits.
   - Provides, to the diverse users of a government's financial reports, more accurate information about the *total cost of the services* that a government provides to its constituents.
   - Clarifies whether the amount a government has paid or contributed for OPEB during the report year has covered its annual OPEB cost. Generally, the more of its annual OPEB cost that a government chooses to defer, the higher will be (a) its unfunded actuarial accrued liability and (b) the cash flow demands on the government and its tax or rate payers in future years.
   - Provides better information to report users about a government's *unfunded actuarial accrued liabilities* (the difference between a government's total obligation for OPEB and any assets it has set aside for financing the benefits) and changes in the *funded status of the benefits* over time.

4. **What are the most common misconceptions about Statement 45?**

   a. **That it requires governments to fund OPEB.** Statement 45 establishes standards for *accounting and financial reporting.* How a government actually finances benefits is a policy decision made by government officials. The objective of Statement 45 is to more accurately reflect the financial effects of OPEB transactions, including the amounts paid or contributed by the government, whatever those amounts may be.

   b. **That it requires immediate reporting of a financial-statement liability for the entire unfunded actuarial accrued liability.** Statement 45 does not require immediate recognition of the unfunded actuarial accrued liability (UAAL) as a financial-statement liability. The requirements regarding the reporting of an OPEB liability on the face of the financial statements work as follows:

      - Governments may apply Statement 45 prospectively. At the beginning of the year of implementation, nearly all governments will start with zero financial-statement liability.
      - From that point forward, a government will accumulate a liability called the *net OPEB obligation*, if and to the extent its actual OPEB contributions are less than its annual OPEB cost, or expense.
      - The net OPEB obligation (not the same as the UAAL) will increase rapidly over time if, for example, a government's OPEB financing policy is pay-as-you-go, and the amounts paid for current premiums are much less than the annual OPEB cost.

      Statement 45 does, however, also require the *disclosure* of information about the *funded status* of the plan, including the UAAL, in the notes to the financial statements—and the presentation of multi-year funding progress trend information as a required supplementary schedule.

   c. **That it requires governments to report "future costs" for OPEB.** It is misleading and incorrect to describe accrual accounting for OPEB as requiring the expensing of "future costs." From an accrual accounting standpoint (the basis of accounting required for all transactions in the government-wide financial statements), the reported expenses relate entirely to transactions (exchanges of employee services for the promised future benefits) that *already have occurred.* Statement 45 requires governments to report costs and obligations incurred as a consequence of receiving employee services, for which benefits are owed in exchange. The *normal cost* component of annual expense is the portion of the present value of estimated total benefits that is attributed to services received in the current year. The annual expense also includes an amortization component representing a portion of the UAAL, which relates to past service costs. Estimated benefit costs associated with *projected future years of service* are *not reported.*

TRANSMITTAL APPENDIX

Information Transmittal

Please provide the following information:

Component Unit Name -____

Primary Contact - ____

Telephone Number - ____

Facsimile Number - ____

Date Submitted - ____

Email Address____

Comptroller's Use

Date Received - ____